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No. 91-1135

Supreme Court, U.S.
FILED
FEB 13 1992

IN THE

Supreme Court of the United States

OCTOBER TERM, 1991

NEWARK MORNING LEDGER COMPANY,
as successor to The Herald Company,
Petitioner,

v.

UNITED STATES OF AMERICA,
Respondent.

On Petition for A Writ of Certiorari to the United States Court of Appeals for the Third Circuit

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BRIEF OF THE AMERICAN BANKERS ASSOCIATION AS AMICUS CURIAE IN SUPPORT OF PETITIONER

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February 13, 1992

PRESS OF BYRON S. ADAMS, WASHINGTON, D.C. (202) 347-8203

19

QUESTION PRESENTED

Whether the Third Circuit, in acknowledged conflict with other circuits and the United States Tax Court, was correct that under the Internal Revenue Code an income-producing wasting intangible asset may be nondepreciable "goodwill" as a matter of law.

TABLE OF CONTENTS

	Page
QUESTION PRESENTED	i
TABLE OF AUTHORITIES	iii
INTEREST OF AMICUS CURIAE	1
SUMMARY OF THE ARGUMENT	3
REASONS FOR GRANTING WRIT	5
I. THE THIRD CIRCUIT'S DECISION CONFLICTS WITH THE DECISIONS OF OTHER CIRCUITS AND MISSTATES EXISTING LAW	5
II. THE THIRD CIRCUIT'S DECISION MISCHARACTERIZES THE STATE OF THE LAW	12
CONCLUSION	13

TABLE OF AUTHORITIES

	Page
CASES:	
AmSouth Bancorporation v. United States, 681 F. Supp. 698 (N.D. Ala. 1988)	11
Citizens and Southern Corp. v. Commissioner, 91 T.C. 463 (1988), *aff'd per curiam*, 900 F.2d 266 (11th Cir. 1990)	*passim*
Colorado National Bankshares v. Commissioner, 60 T.C.M. (CCH) 771 (1990)	11
Donrey, Inc. v. United States, 809 F.2d 534 (8th Cir. 1987)	*passim*
First Pennsylvania Banking & Trust Co. v. Commissioner, 56 T.C. 677 (1971)	9
Houston Chronicle Publishing Co. v. United States, 481 F.2d 1240 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974)	*passim*
IT&S of Iowa, Inc. and Iowa Trust and Savings Bank v. Commissioner, 97 T.C. No. 34 (November 12, 1991)	11
Laird v. United States, 556 F.2d 1224 (5th Cir. 1977), *cert. denied*, 434 U.S. 1014 (1978)	8
McCarthy v. United States, 807 F.2d 1306 (6th Cir. 1986)	7
Midlantic National Bank/Merchants v. Commissioner, 46 T.C.M. 1464 (1983)	10
Panichi v. United States, 834 F.2d 300 (2nd Cir. 1987)	6
Ralph W. Fullerton Co. v. United States, 550 F.2d 548 (9th Cir. 1977)	7
STATUTES:	
26 U.S.C. section 167 (1988 & West Supp. 1991)	4

Table of Authorities Continued

	Page
LEGISLATIVE MATERIALS:	
H.R. 3545, 100th Cong., 1st Session, 133 Cong. Rec. H8980 (1987)	12
ADMINISTRATIVE MATERIALS:	
Treasury Regulation Section 1.167(a)-3	6
Rev. Rul. 65-175, 1965-2 C.B. 41	7
Rev. Rul. 65-180, 1965-2 C.B. 279	7
Rev. Rul. 74-456, 1974-2 C.B. 65	7,12

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BRIEF OF THE AMERICAN BANKERS ASSOCIATION AS AMICUS CURIAE IN SUPPORT OF PETITIONER

INTEREST OF THE AMICUS CURIAE

The American Bankers Association ("ABA") is the principal national trade association of the commercial banking industry in the United States. ABA members are located in each of the fifty states and the District of Columbia and represent banks of all types and sizes—money center, regional and community banks. ABA members hold approximately ninety percent of the domestic assets of United States banks.

The decision of the Third Circuit Court of Appeals in the above referenced case raises issues of major importance to commercial banks across the nation. The tax treatment for the amount paid by Newark

Morning Ledger Company for subscriber relationships is similar to the treatment that financial institutions use in their purchases of bank-related intangible assets. In the court below's decision, a reference is made that the core deposit intangible is akin to subscriber relationships and therefore, under their analogy, may not be amortizable. As such, the decision of the Third Circuit exposes financial institutions located in that jurisdiction and in other jurisdictions which have not addressed the depreciation of bank-related intangible assets to unwarranted risk, and conflicts directly with judicial and long-standing policies of the Internal Revenue Service ("IRS"). The Third Circuit's decision represents a substantial and legally unjustified shift in the law of depreciation of intangible assets.

The Third Circuit's decision incorrectly characterizes the law of depreciation of intangible assets established by judicial decisions as well as the regulations and rulings of the Internal Revenue Service. The Third Circuit's holding sows confusion over the allowability of depreciation deductions for mortgage servicing rights, core deposits, and other intangible assets routinely acquired by banks in connection with the purchase of a going concern. The Third Circuit's attempt to impose a *per se* legal standard in lieu of a facts and circumstances test for the depreciability of intangible assets is fundamentally inconsistent with decades of settled legal authority and makes it extremely difficult to determine what tax consequences a bank may expect to result from the purchase of another bank.

Consideration of the facts and circumstances in the banking industry, in particular, demonstrates the fallacy of the Third Circuit's attempt to impose a *per se* rule denying depreciation deductions. The effect of the Third Circuit's decision is to create great uncertainty as to the cost of bank acquisitions and to jeopardize the depreciation deductions claimed by banks located in that jurisdiction as well as banks located in other jurisdictions in which a similar attempt may be made to abandon established precedent governing the depreciation of intangible assets.

The American Bankers Association is in a unique position to express the views of financial institutions regarding the issues raised in this case. Core deposits (*e.g.*, deposit transaction accounts, savings accounts) are the life blood of a commercial bank's existence and are the most valuable assets acquired in the purchase of a bank. The acquiring bank is willing to pay a "premium" for the value of these deposits as they represent a ready source of funds that the acquiring institution can immediately employ, albeit for a limited time. If this decision is allowed to stand, the banking industry may bear significant, negative consequences if the decision is interpreted broadly by other courts and the Internal Revenue Service. The American Bankers Association believes that its views would be of assistance to the Court in determining whether this matter merits further review. Counsel for both parties have consented to our appearance as amicus curiae. Copies of their written consents are filed together with this brief.

SUMMARY OF THE ARGUMENT

The Petition for Writ of Certiorari describes the serious practical problems created by the Third Circuit's ruling for purchasers of intangible assets from

going concerns. This brief explains the adverse impact of the court's ruling on the banking industry. In particular, the analogy made by the Third Circuit between the amortizability of the core deposit intangible in the context of bank acquisitions and the amount paid for subscriber relationships in the case of newspaper acquisitions concerns our members.

The decision by the Third Circuit misconstrues the standard for depreciation of intangible assets under section 167 of the Internal Revenue Code, 26 U.S.C. Section 167 (1988 & West Supp. 1991). Prior to the decision of the Third Circuit, modern judicial decisions interpreting the Internal Revenue Code and Treasury regulations had unanimously held that entitlement to depreciation is a question of fact, and established that an asset is depreciable if, as a matter of fact, it has an ascertainable value separate and distinct from goodwill and a limited useful life that can be estimated with reasonable accuracy. The case law, until now, has been quite clear that those questions, including specifically, whether an asset is "separate and distinct" from goodwill, are questions of fact.

In the ruling below, however, the Third Circuit ignored or mischaracterized the case law pertaining to depreciation of intangible assets in order to create a new legal standard. In essence, the court below erroneously viewed the dispute not as a question of fact but as a question of law.

The question analyzed by the Third Circuit was whether an asset is necessarily separate and distinct from goodwill if it has both a separate value and a limited life. The Third Circuit, however, did not address the question whether the subscriber relationships acquired by the taxpayer were, as a matter of

fact, separate and distinct from goodwill. Instead, the decision of the court established a new legal standard that a customer-based intangible cannot be separate and distinct from goodwill if it is acquired in the context of the purchase of all the assets of a going concern.

In changing from a factual standard to a legal standard that establishes a *per se* rule of nondepreciability, the Third Circuit's decision is a complete break from the modern case law of intangible asset depreciation. The Third Circuit's holding would appear to virtually bar depreciation of customer-based intangible assets acquired in the context of the purchase of an ongoing business. For that reason, the court's holding is already sending shock waves through the banking community and other industries in which the purchase and sale of customer-based intangibles play a major role.

The Third Circuit's mischaracterization of the law of depreciation of intangible assets has potential ramifications far beyond the particular intangible asset and the particular taxpayer at issue in this case. The American Bankers Association urges the court to grant the Petition for Writ of Certiorari and to consider the significance of these issues and the disparate treatment of similarly situated taxpayers which is likely to occur if this decision is permitted to stand.

REASONS FOR GRANTING WRIT

I. The Third Circuit's Decision Conflicts With The Decisions Of Other Circuits And Misstates Existing Law.

The Third Circuit's holding incorrectly characterizes the law of depreciation of intangible assets established

by judicial decisions as well as the regulations and rulings of the Internal Revenue Service.

The basic elements necessary to depreciate an intangible asset are set forth in section 167(a) of the Internal Revenue Code and section 1.167(a)-3 of the Treasury regulations. These authorities have been interpreted by the landmark case of *Houston Chronicle Publishing Co. v. United States*, 481 F.2d 1240 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974) and subsequent cases as establishing a two-part test: (1) the asset must have an ascertainable value separate and distinct from goodwill, and (2) the asset must have a limited useful life that can be ascertained with reasonable accuracy.

The *Houston Chronicle* decision ushered in the modern era of judicial decisions involving the depreciation of intangible assets. *Houston Chronicle* held that the determination of whether an asset satisfies the standard for depreciation is a factual determination. In that case, the Government argued that the acquired newspaper subscriber relationships should be considered nondepreciable as a matter of law. After an exhaustive review of the case law, the Fifth Circuit rejected the Government's argument. The court concluded that most of the cases applying the "mass asset" rule, a sobriquet for the *per se* rules of nondepreciability urged by the Government, involved *evidentiary* failures on the part of the taxpayer. With the exception of the Third Circuit's decision, the *Houston Chronicle* holding that depreciation is available if the taxpayer can make the necessary *factual* showing has been approved by all of the appellate courts to consider the issue. *See, e.g., Panichi v. United States*, 834 F.2d 300 (2nd Cir. 1987); *Donrey, Inc. v. United States*, 809 F.2d 534 (8th Cir. 1987); *McCarthy v. United States*, 807 F.2d 1306 (6th Cir. 1986); *Ralph W. Fullerton Co. v. United States*, 550 F.2d 548 (9th Cir. 1977); *Citizens and Southern Corporation and Subsidiaries v. Commissioner*, 91 T.C. 463 (1988), *aff'd per curiam*, 900 F.2d 266 (11th Cir. 1990).

More than 25 years ago, the Commissioner issued several revenue rulings which suggested that certain intangible assets were nondepreciable as a matter of law. *See* Rev. Rul. 65-175, 1965-2 C.B. 41, and Rev. Rul. 65-180, 1965-2 C.B. 279. One year after the Fifth Circuit's seminal decision in *Houston Chronicle*, the Commissioner modified his 1965 rulings to remove any implications that customer-based intangibles, and similar assets, are indistinguishable from goodwill as a matter of law; and instead, stated that the depreciability of assets of this nature is a factual question. *See* Rev. Rul. 74-456, 1974-2 C.B. 65, 66.

In short, the case law and the Commissioner's own rulings make plain that there are no *per se* rules. Nevertheless, the Third Circuit's decision misapplies the case law in order to create a *per se* rule that purports to deny depreciation in the case of customer-based intangibles acquired in connection with the purchase of a going concern.

Although the court below recognized and indeed purported to apply the holding of *Houston Chronicle*, it was so severely misapplied that the *per se* rule adopted by the Third Circuit is the very same litigating position rejected by the Fifth Circuit in *Houston Chronicle*. In all of the intangible asset depreciation cases since *Houston Chronicle*, no appellate court has ever taken the position adopted by the court below. For example, in *Donrey*, the Eighth

Circuit upheld the depreciability of newspaper subscriber relationships acquired from a going concern.

The court below dismisses *Donrey* by making the startling claim that *Donrey* is inconsistent with *Houston Chronicle*. Far from being inconsistent with *Houston Chronicle*, *Donrey*, instead, is a straightforward application of the rule of *Houston Chronicle* that entitlement to depreciation is a question of fact. One of the facts determined by the trier of fact (in that case a jury) was that the newspaper subscriber relationship acquired by the taxpayer was an asset that is separate and distinct from goodwill. Accordingly, applying the *Houston Chronicle* test, the taxpayer was entitled to depreciate the value of the acquired asset over its limited useful life.

Although the Third Circuit conjured up an imaginary conflict between the Fifth Circuit (*Houston Chronicle*) and the Eighth Circuit (*Donrey*), it curiously failed even to mention the Fifth Circuit's application of the rule of *Houston Chronicle* in the context of intangible assets acquired from a going concern. In *Laird v. United States*, 556 F.2d 1224 (5th Cir. 1977), *cert. denied*, 434 U.S. 1014 (1978), for example, the Fifth Circuit upheld the depreciability of intangible assets acquired in the purchase of a going concern football franchise. Apparently, in the Third Circuit's erroneous view of the law, the Fifth Circuit is inconsistent with itself.

The court below states flatly that "customer lists are generally not depreciable when acquired in conjunction with the sale of the underlying business as a going concern." It may well be that, in any given case, a taxpayer cannot carry its burden of proving that, as a factual matter, an acquired customer-based

intangible is separate and distinct from goodwill. Rather than treat the issue as a question of fact, however, the court below reached its own conclusion, apparently applying a legal standard that establishes a *per se* rule of nondepreciability in cases involving customer-based intangibles purchased as part of a going concern. In so doing, the Third Circuit committed legal error by ignoring the teaching of *Houston Chronicle*, *Citizens and Southern*, *Donrey*, and the many other cases holding that there are no *per se* rules and that entitlement to depreciation is a question of fact. This conflict amongst the circuits must be resolved.

The Third Circuit's ultimate conclusion that the subscriber relationship in this case is not separate and distinct from goodwill may or may not be a proper outcome of the *factual* inquiry that is necessary in a depreciation case; but it clearly is not a proper conclusion based solely on a legal theory of a *per se* rule in lieu of a factual inquiry. For that reason, the American Bankers Association urges the court to grant the Petitioner's Writ of Certiorari.

By fundamentally altering the basic legal standard for depreciation of intangible assets, the Third Circuit's decision will wreak havoc and create devastating uncertainty concerning the treatment of purchased intangible assets. Banks and bank holding companies often acquire intangible assets when purchasing other banks, and these acquisitions occur with respect to failed banks as well as banks that are going concerns. The depreciability of some intangible assets, like mortgage servicing rights, has been settled law for decades and even now is unchallenged. *See, e.g.*, *First Pennsylvania Banking & Trust Co. v. Commissioner*,

56 T.C. 677 (1971), and cases cited therein. Other intangible assets have been held to be depreciable if they can satisfy the *Houston Chronicle* standard with proof of an ascertainable useful life and a value separate and distinct from goodwill.

The Third Circuit's faulty analysis of core deposit intangibles is disturbing because it ignores the facts of life in the banking industry as well as the established case law. In the banking industry, core deposits represent the literal life blood of a commercial bank's existence. The deposit transaction accounts, regular savings accounts and similar accounts afford a bank with a source of funds for a limited but predictable period of time. The acquiring bank is willing to pay a "premium" for these accounts as they provide the acquiring institution with immediate funds from which it can serve the local community. The value of an acquired group of core deposits can be determined by recognized valuation methods—and indeed, is one of the most valuable assets obtained in the purchase of a bank. The core deposit intangible is recognized by bankers, bank regulators, and accounting authorities as a separate source of value, separate and distinct from goodwill—and is purchased and sold in the marketplace in connection with the purchase of both failed institutions and going concerns.

Whether purchased from a failed bank or a going concern, the core deposit intangible asset is the same. It is a separate asset, with a limited useful life, and therefore is depreciable. In *Midlantic National Bank/ Merchants v. Commissioner*, 46 T.C.M. 1464 (1983), the Tax Court held in a memorandum decision that the value of the right to solicit the core deposits of a failed bank was a depreciable asset. In *Citizens and*

Southern, the entire Tax Court, in a reviewed decision, held that the value of the core deposits acquired from a going concern was an asset separate and distinct from goodwill, and that the value of that asset (measured by the cost savings of the acquired deposits over the cost of replacing those funds with the market alternative source of funds) is depreciable over its limited life.

Citizens and Southern was affirmed *per curiam* by the Eleventh Circuit. Although a bank was denied depreciation of an acquired deposit base in the earlier decision of *AmSouth Bancorporation and Subsidiaries v. United States*, 681 F.Supp. 698 (N.D. Ala. 1988), the court in that case was careful to state that depreciation was denied due to a failure of proof. The decision in *AmSouth Bancorporation* was appealed to the Eleventh Circuit, but the appeal was withdrawn before the Eleventh Circuit affirmed *Citizens and Southern*. Subsequently, *Citizens and Southern* was followed in the Tax Court memorandum decision in *Colorado National Bankshares v. Commissioner*, 60 T.C.M. (CCH) 771 (1990). Even more recently, after the Third Circuit's decision below, *Citizens and Southern* was again followed and reaffirmed by a reviewed decision of the entire Tax Court in *IT&S of Iowa, Inc., and Iowa Trust and Savings Bank v. Commissioner*, 97 T.C. No. 34 (November 12, 1991).

By attempting to impose a *per se* rule that ignores the facts in any particular case, the Third Circuit's decision introduces enormous uncertainty concerning the proper legal standard for depreciation of intangible assets, even intangible assets that are clearly recognized to be separate from goodwill. Every other circuit to consider the depreciation of intangible as-

sets has acknowledged that entitlement to depreciation is a question of fact. If permitted to stand, the Third Circuit's decision will continue to interfere with the administration of our tax system in a fair and consistent manner, and obstruct the purchase and sale of financial institutions and other businesses by creating unnecessary uncertainty concerning the tax consequences of purchasing intangible assets.

II. The Third Circuit's Decision Mischaracterizes The State Of The Law.

The Third Circuit's decision ignores the fact that, since *Houston Chronicle*, the law has been clear that depreciation is aquestion of fact. As even the Commissioner recognized in Rev. Rul. 74-456, customer-based intangibles, like other intangible assets, are eligible for depreciation if, as a matter of fact, they are separate and distinct from goodwill and have a limited useful life and a determinable value.

Congress has specifically declined to enact the proposed rule offered by the Commissioner, and apparently accepted by the Third Circuit, that some assets be declared nonamortizable as a matter of law. Indeed, Congress considered precisely such a proposal in 1987. Section 10120 of H.R. 3545, the Revenue Bill of 1987, proposed to deny amortization of subscriber relationships and similar intangible assets. Although H.R. 3545 was enacted as Title X of the Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, 101 Stat. 1330, 1330-382 (1987), Congress did not enact the provision denying amortization of customer-based intangibles and similar assets, and has not enacted any of the more recent proposals to deny amortization of customer-based intangible assets.

The Third Circuit's decision has injected a great deal of confusion into this area as it departs from the settled standards established by other appellate decisions. This decision compounds the uncertainty of difficult factual determinations by introducing uncertainty even as to the underlying legal standard for depreciation in different circuits. That confusion can be rectified only by applying the same standard for depreciation in this case that has been applied in all of the appellate decisions since *Houston Chronicle*.

CONCLUSION

The decision in this case holds that, as a matter of law, a customer-based intangible is not depreciable when acquired in conjunction with the purchase of the entire business as a going concern. The overly-broad nature of the Third Circuit's decision causes great disruption in the acquisition of intangible assets. Given this disruption, the facts and circumstances test established by the *Houston Chronicle* decision should remain the legal standard for the amortizability of intangible assets.

The Petition for Writ of Certiorari should be granted and the decision of the Third Circuit should be reversed.

Respectfully submitted,

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